Summary: Defined Benefit 529 Surplus Funds

WHAT WE FOUND

The findings for this report are based on the June 2021 actuarial valuation of the Defined Benefit 529 (DB529) fund, which showed a funded status of 194 percent and an actuarial surplus of $1.6 billion. This was the most recent actuarial information available at the time that JLARC staff conducted this study. As of June 2022, the DB529's funded status had declined to 188 percent, and the actuarial surplus had declined to approximately $1.4 billion because of recent market declines. The actuarial valuation and funded status vary annually but have steadily increased over the longer term, and recent changes do not affect the overall findings, recommendations, or options in this report.

Funded status of the DB529 fund is higher than needed to cover future obligatons

According to JLARC's independent actuary, the funded status of the DB529 fund is much higher than needed to cover the future obligations of Virginia529's two defined benefit plans—the Legacy Prepaid529 program and the new Tuition Track Portfolio (TTP). The actuary advised that a lower funded status in the range of 125 percent is reasonable for a defined benefit college savings program. At a funded status of 125 percent, there is a 90 percent probability of having sufficient assets to meet Virginia529's defined benefit obligations. Other states have taken action at around 125 percent to 135 percent to either reduce (or consider reducing) the actuarial surplus in their prepaid college savings programs.

If all actuarial surplus funds remain in the DB529 fund, the FY21 actuarial surplus of $1.6 billion is projected to increase and reach more than $3.7 billion by the end of FY44, when all Legacy Prepaid529 tuition obligations are expected to have been paid. This will increase the already unnecessarily high funded status, and opportunities to put those funds to other higher education uses that could have a substantial beneficial impact will be forgone.

WHY WE DID THIS STUDY

The Virginia College Savings Plan Oversight Act (§§30-330 through 30-335 of the Code of Virginia) requires JLARC to conduct ongoing oversight of Virginia529 and its programs. As part of this ongoing oversight, JLARC members approved a motion in July 2021 for JLARC staff to review the extent to which actuarial surplus funds from the Legacy Prepaid529 program can be used to support higher education access and affordability in Virginia. In addition, the 2022 Appropriation Act (Item 497.D of Chapter 2, 2022 Act of Assembly, Special Session I) directed JLARC to review evidence of the effectiveness of Virginia529's SOAR Virginia program and other access and affordability programs supported by Virginia529. To conduct this study, JLARC staff worked with an independent actuary, an independent investment consultant, and an independent legal consultant.

ABOUT THE DEFINED BENEFIT 529 FUND

Virginia529 operates two defined benefit college savings programs—Legacy Pepaid529, which was closed to new participants in 2019, and the new Tuition Track Portfolio (TTP), which opened in 2021. Defined benefit college savings programs provide a guaranteed payout to participants for future college tuition and fees. For actuarial and investment purposes, Virginia529 combines its two defined benefit programs into a single Defined Benefit 529 fund.

$1.3 billion in DB529 surplus funds could be safely withdrawn over at least five years based on 2021 surplus

Actuarial surplus funds could be removed from the DB529 fund while maintaining a high probability that the fund's assets will be sufficient to meet the programs' liabilities. The amount of surplus funds that could be removed depends on the investment return and tuition growth assumptions used. Using the Virginia529 board's realistic assumptions of 5.5 percent for the investment return and 6 percent for long-term tuition growth annually, approximately $1.3 billion in surplus funds could be removed—over a time period of at least five years—while maintaining a funded status of at least 125 percent (based on the 2021 valuation).

JLARC's independent actuarial and investment consultants recommended that funds be removed from the DB529 fund in annual increments over at least five years, rather than all at once. This approach would spread out the impact on the funded status, ensuring that it does not decline too quickly after funds are removed. It would also help ensure the fund has enough liquid assets to make benefit payments to account holders. The consultants indicated that removing surplus funds incrementally would allow for regular reviews of the DB529 fund to ensure that withdrawing funds continues to be prudent from an actuarial and investment standpoint.

Surplus fund withdrawals should be mandated in law and approved by an independent committee

Specifying the withdrawal of actuarial surplus funds in statute, but making withdrawals subject to review and approval by an independent committee, would ensure appropriate flexibility and fidelity with the General Assembly's intent. Specifying the process in statute would ensure that the withdrawals occur, because they would be required except under certain defined situations or if the independent committee advised against it. This process would provide flexibility, because the independent committee could reduce or pause withdrawals if changing market or tuition conditions showed that removing additional surplus funds would jeopardize the DB529 fund's solvency or liquidity.

DB529 surplus funds from account holder payments could be returned to account holders

Approximately 60 percent of the total actuarial surplus is derived from payments by Legacy Prepaid529 account holders. If $1.3 billion in surplus funds were removed from the DB529 fund, 60 percent (approximately $780 million) could be returned to current and past account holders.

One option for returning actuarial surplus funds to Legacy Prepaid529 account holders would be providing all account holders a minimum tuition benefit equal to at least the enrollment-weighted average tuition (WAT) at all of Virginia's public four-year higher education institutions. This approach would be consistent with the new TTP program. This option would benefit the nearly 30 percent of account holders whose student previously attended a postsecondary institution with lower cost (below-WAT) tuition or whose beneficiary attends a below-WAT institution in the future. However, this option would not fully utilize the surplus funds available from account holders, so additional funds could be returned to account holders in other ways or used to support higher education access and affordability programs.

A second option for returning actuarial surplus funds to Legacy Prepaid529 account holders is to reprice all legacy contracts based on WAT. Account holders could receive a refund if their contract was priced above WAT at the time they purchased the contract. This option would benefit more account holders, because approximately 70 percent of legacy contracts were originally priced above WAT. This was largely because of Virginia529's historical use of a pricing reserve to protect the DB529 fund from lower-than-expected investment returns and higher-than-expected tuition increases.

A third option for returning surplus funds would be to provide Legacy Prepaid529 account holders the same refund for each prepaid contract they purchased. While this option would be administratively simpler, account holders—including those who have already received larger benefits because their beneficiaries attended above-WAT institutions or their contracts were priced below WAT—would receive the same refund per contract as all other account holders.

DB529 surplus funds from fee proceeds could support higher education access and affordability

Approximately 40 percent of the total actuarial surplus is derived from administrative fee proceeds that Virginia529 allocated to the DB529 fund over time to strengthen the fund's solvency. These proceeds largely come from fees associated with Virginia529's savings programs, primarily the national CollegeAmerica, which is sponsored by Virginia529. If $1.3 billion in surplus funds were removed from the DB529 fund, 40 percent (approximately $520 million) could be used to support higher education access and affordability.

Actuarial surplus funds from administrative fee proceeds (which were largely paid by residents outside Virginia) provide a unique opportunity for Virginia to support a wide variety of programs to enhance higher education access and affordability. The state could use surplus funds to

- provide additional grants and scholarships for the highest financial need students enrolling in a postsecondary institution,
- provide larger progression bonuses to students at four-year institutions as they progress to their sophomore, junior, and senior years,
- establish a pilot program to provide grants for students close to completing a degree but at risk of dropping out because of a financial emergency, or

- expand the availability of support services for students at risk of not enrolling in or completing a postsecondary program.

Creating a dedicated fund for higher education access and affordability would provide flexibility and a long-term funding source

Rather than spending all of the actuarial surplus funds allocated for access and affordability in the years they are withdrawn or shortly thereafter, the funds could be placed in a dedicated fund to support higher education access and affordability, which could function similarly to an endowment. A dedicated fund would

- enable the state to assist students over many more years with attending higher education institutions,
- enable the state to address higher education needs as they change over time, and
- allow the surplus funds to be made available to the DB529 fund if concerns arose regarding the fund's solvency or liquidity.

A dedicated higher education fund could provide up to $39 million annually depending on how it is structured. If future Virginia529 administrative proceeds (estimated at $15 million annually based on recent years) were allocated to the fund, even more funding could be available through the dedicated fund annually to support higher education access and affordability. The primary disadvantage of a dedicated fund is that fewer funds would be available in the near term.

State Council of Higher Education for Virginia should make allocations from dedicated fund subject to authorized uses in statute

The State Council of Higher Education for Virginia (SCHEV) is in the best position to effectively make allocations from the dedicated fund to the types of higher education access and affordability programs that the General Assembly has authorized in statute. SCHEV has a mission that aligns with higher education access and affordability, and council members and staff have expertise in higher education. SCHEV could establish an advisory committee to ensure it is making informed decisions when allocating dedicated funds. The advisory committee could examine options for allocating funds for access and affordability within the guidelines established by the General Assembly and make recommendations to the council.

Dedicated fund assets could remain in the DB529 fund and be managed by Virginia529

Virginia529 is the most appropriate entity to effectively manage the assets in a dedicated higher education access and affordability fund. Assets must be managed to provide investment earnings to support the fund's purposes. Virginia529 investment staff have experience managing investments for the range of assets, including private market assets, which would be needed to provide sufficient investment earnings. Leaving dedicated fund assets in the DB529 fund, but accounting for them separately, would also ease the need to generate additional liquidity in the DB529 fund.

WHAT WE RECOMMEND

Legislative action

- Direct the removal of actuarial surplus funds from the DB529 fund 1) in annual increments over a period of at least five years, and 2) up to an amount that would maintain an annual funded status of at least 125 percent.
- Establish an independent standing committee with investment and actuarial expertise to review and approve each planned withdrawal based on updated actuarial and liquidity modeling.
- Authorize the use of actuarial surplus funds from the DB529 fund for 1) returning funds to Legacy Prepaid529 account holders and 2) programs supporting higher education access and affordability.
- Use actuarial surplus funds in the DB529 fund that derive from administrative fee proceeds to create a dedicated fund for higher education access and affordability.
- Authorize the types of access and affordability programs that could receive dedicated funds and give SCHEV responsibility for allocating funds within these statutory guidelines.
- Direct Virginia529 to manage the investment of dedicated fund assets.

The complete list of recommendations is available on page vii.